

# Life Advice About.... 401(K) Plans

This **Life Advice®** guide about *401(k) Plans* was produced by the **MetLife Consumer Education Center** with assistance from the Internal Revenue Service and the Financial Planning Association.

---

## [What Is a 401\(k\) Plan?](#)

[Benefits from investing in a 401\(k\) plan](#)

[How much can I contribute?](#)

[Your employer may make matching contributions](#)

## [What Are Your Investment Options?](#)

[Stable Value Funds](#)

[Company Stock](#)

[Mutual Funds](#)

[Balanced Funds \(Life Style Funds or Asset Allocation Funds\)](#)

[Questions to ask when choosing your 401\(k\) Plan investments](#)

[What If I Leave My Current Employer?](#)

[What If I Need the Money Before I Retire?](#)

[Some Tips for Savvy 401\(k\) Investing](#)

[Make the Most of Your 401\(k\)](#)

[For More Information](#)

Many Americans today are living longer, healthier lives, which could mean additional retirement years for which you may have to provide an income. It's up to you to make yours a comfortable retirement. In most instances, Social Security alone will not provide you with as much money as you were earning before you retired. That's where a 401(k) comes in.

Fortunately, you may have access to a powerful retirement tool that can provide a portion of your retirement income—a 401(k) plan provided through your employer. What you get out of a 401(k) depends on how much you put in and how wisely you invest your monies. This pamphlet can help you reap the full benefits of your plan.

## **What Is a 401(k) Plan?**

A 401(k) plan\* (named after a section of the federal tax code) is an employer established plan somewhat similar to an Individual Retirement Account (IRA). Both plans are designed primarily as retirement savings plans. A 401(k) plan is generally funded with your before-tax salary contributions and, oftentimes, matching contributions from your employer. Your contributions, employer contributions (if any) and any growth in the 401(k) is tax-deferred until you withdraw the money. Once money is in your 401(k), you generally cannot make withdrawals before age 59½, except for special circumstances. Many employers, however, include loan provisions in their plans.

\* Employees of most tax-exempt organizations (except for state and local governments and their agencies) are eligible for 401(k) plans. Many tax-exempt organizations, however, such as hospitals, social service agencies, libraries, K-12 public schools, colleges and universities are covered under another plan, the 403(b). If such a tax exempt organization employs you, you might want to check out the Life Advice® brochure, 403(b) Plans.

## **Benefits from investing in a 401(k) plan**

- Your contributions, any employer contributions and any earnings on your 401(k) account grow tax-deferred; which means they are not taxed until they are withdrawn. Consequently, you have more dollars working for you, and your account balance may grow more quickly.

- Your current gross income is reduced by the amount you contribute. Contributions are usually made pre-tax, which means you are not subject to Federal (or most state) income tax on your contributions to the plan until the money is withdrawn, typically at retirement. You may be in a lower tax bracket at that time; if so, you would pay less tax. This also means you have more money in your account working for you. Contributions are subject to Social Security and Medicare taxes.
- Automatic payroll deductions make saving for retirement easy. You're less likely to miss money you never see.
- You can control your own account. Unlike traditional pension plans, 401(k) plans often allow participants to choose how to invest their contributions. Participants can be as aggressive or as conservative as you wish in selecting investment options offered under the plan.
- The plan is "portable." When you leave your current employer, you can have the option of rolling your 401(k) money over into an IRA (Individual Retirement Account) or a new employer's plan or withdrawing the money. Keep in mind, however, that withdrawing money before age 59½ will mean you will pay taxes on the withdrawal, and generally an early-withdrawal penalty of 10 percent if the money is not rolled over or directly transferred to an IRA or another qualified retirement plan on a tax-deferred basis.
- You can invest in professionally managed funds at no minimums. Retail financial service providers may impose minimum investment requirements. With a 401(k) you can get started investing a little at a time.
- You may be able to borrow from your account. Many plans have loan features that let you withdraw money (without taxes or penalties) as a "loan to yourself." You may be able to pay the loan back automatically through payroll deduction, and the loan interest goes into your own account, too.
- Your employer may contribute "matching" funds on a portion of your savings. If so, you reap instant benefit from contributing to your plan. For example, if your employer contributes 50% of the amount you contribute, you would receive an additional \$50 added to your account for every \$100 you contribute, up to the plan limits.

### **How much can I contribute?**

Your employer's specific 401(k) plan will allow you to contribute up to a certain percentage of your before-tax pay; tax law limits the maximum you may contribute each year. If you are age 50 or older, you may make catch-up contributions. That is, you are allowed to contribute extra amounts over and above your before-tax contribution limit.

In 2006, the maximum dollar amount the law allows an employee to contribute from before-tax pay is \$15,000. In years after 2006, your contribution limit will be increased periodically to adjust for inflation.

### **Your employer may make matching contributions**

Not all employers make matching contributions, and those who do may contribute at different levels. A typical match might be 25 to 50 percent of your own contribution up to a certain level. Your own contributions to your 401(k) plan are automatically yours to keep, but you may have to be "vested" before you are entitled to your employer's matching contributions. This means having a certain level of service with your company, often three years. Some plans have graduated scales for vesting. For example, you may be 50% vested after two years and 100% vested after three years. With other plans, you may be entitled to receive your employer's contributions immediately, without waiting to be vested.

Usually you are eligible to join a 401(k) plan if you:

- Are an eligible employee of a company that offers such a plan
- Are over the age of 21
- Have worked for the company for a specified length of time (not to exceed 1 year).

For full information on the rules governing your employer's 401(k) plan, ask your plan administrator or human resource representative for a Summary Plan Description (SPD).

## What Are My Investment Options?

Most 401(k) plans offer a number of investment options for your money. A typical plan may offer six-to-eight options, but some offer an even broader range. If the plan allows you to direct the investments in your account, it's up to you to decide how to divide your money among the available options. The choices you make may have a tremendous impact on the ultimate value of your 401(k), so it just makes good sense to educate yourself about the potential risks and rewards of each type of financial vehicle available to you. You may put your money in just one option or you may divide your contributions among various options - some with higher risk and some with lower risk. Among the possibilities that may be available to you are the following:

**Stable Value Funds.** These funds are designed to provide consistent, predictable growth over the long term. Sometimes called the “Fixed Fund” or “Guaranteed Fund,” these funds are typically backed by contracts issued by insurance companies, such as “Guaranteed Interest Contracts” or “GICs.” This option is generally considered lower risk and is guaranteed by the issuing insurance company, but fixed interest rates and rising inflation can erode its earning power. Be sure to check the financial health of the companies issuing the GICs and other contracts. Firms such as Moody's, A.M. Best or Standard & Poor's, issue financial ratings of insurance companies.

**Company Stock.** By selecting your employer's stock, you acquire an ownership interest in the company. Buying the stock of any single company—including your employer, however, carries a very high degree of risk and generally should represent only a small portion of your investment portfolio.

**Mutual Funds.** These options pool money from many investors and can invest it in various securities such as stocks, bonds and money market instruments. They are designed to help reduce (but not eliminate) risk. If you further diversify by purchasing shares in more than one plan option, your risk may be reduced even more. Among the types of accounts that may be available to you in your 401(k) plan are:

**Money Market Funds.** The assets in these funds typically consist of U.S. Treasury bills, Certificates of Deposit (CDs) and other commercial investments. You'll find them on the lowest rung of the risk ladder. On the other hand, they also offer the lowest potential for return and may not beat inflation. An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the money market funds seek to preserve the value of the investment at \$1.00 per share, it is possible to lose money by investing in a money market fund.

**Bond mutual funds** typically invest in government or corporate bonds, or a combination of both. Government bond mutual funds can invest in U.S. Government, state government, or local government bonds. Corporate bond mutual funds invest in a variety of bonds from companies across the country or around the world.

Bond mutual funds are subject to the performance of the bonds in their portfolio, and risk varies according to investment strategy. Generally, funds holding bonds with longer average-maturity periods have higher yield potential and higher risk. Bond mutual funds with a shorter average maturity are generally lower risk investments. Overall, bond mutual funds are low- to moderate-risk investments, with a few categorized on the high-risk side. Independent agencies such as Standard & Poor's and Moody's rate bonds in the marketplace according to risk.

**Stock mutual funds** are usually invested in various publicly traded stocks. A stock mutual fund's value can rise or fall quickly over the short term. While past performance is not a guarantee of future results, historically stocks have performed better over the long term than other types of investments (e.g., government bonds, treasury securities). Stock prices fluctuate for a wide range of reasons, and stock mutual funds are subject to the same market risk as stocks. Not all stock mutual funds are the same or have the same level of risk. Most stock mutual funds fall into one or more of the following categories.

- *Index mutual funds* attempt to mirror the performance of stock market indexes, such as the Dow Jones Industrial Average or the Standard & Poor's 500 Composite Stock Price Index (S&P 500). They do this by investing in all (or a representative sample) of the companies included in the index. Investing in an index mutual fund reduces the risk that the fund portfolio will be subject to poor investment

decisions. The downside to these mutual funds is that they're managed for average performance, so they rarely perform significantly better than the market in general.

- *Growth mutual funds* invest in companies that have better-than-average growth potential over time. The earnings of these companies, and therefore their stock values, are expected to increase. Growth mutual fund investments span a broad range of industries, and may or may not pay dividends. Growth funds are considered higher risk, so expect significant fluctuation in share price.
- *Income mutual funds* invest in stocks that have a history of paying regular dividends. These investments tend to fall in the middle of the risk spectrum for stock mutual funds.
- *Growth and income mutual funds* generally invest in companies believed to have growth potential and a solid dividend payment record. They're designed to help you hedge your bets—even if the share price falls, dividends may offset the loss. Growth and income fall in the middle of the risk spectrum for stock mutual funds.
- *Aggressive Growth mutual fund* portfolios include stocks of start-up companies, smaller businesses or firms in high-risk industries. These stocks may be volatile and should be purchased by those with a higher risk tolerance.
- *International mutual funds* generally invest in stocks or bonds of non-U.S. issuers. Investors in these funds are taking on a high degree of risk, since the portfolios could be affected by political unrest or currency fluctuations in a foreign country. Often, international mutual funds invest in companies from *emerging markets* where business is rapidly developing (e.g. Latin America). The potential risks and rewards are very high.

**Balanced Funds (Life Style Funds or Asset Allocation Funds).** Blending both stocks and bonds, these funds allow diversification with potentially lower risk than pure stock funds, but also with a lower potential for return.

### Questions to ask when choosing your 401(k) Plan investments

Each type of investment has its own degree of certainty and uncertainty. Since all investments perform differently, one way to manage risk is to diversify your portfolio by investing in a blend of different types of assets. Keep in mind that 401(k) options are not federally insured, and past performance is not a guarantee of future results. Your employer's 401(k) plan will most likely offer you a variety of investment choices. Asking the right questions will help you decide on your best investment strategy.

- **Have I learned all that I can about each investment?** For mutual funds, the prospectus, financial magazines are good sources of information. For other types of investments, talk with your plan administrator.
- **How has this investment performed in the past?** While past performance is never a guarantee of future performance, it will help to give you an idea of how the different types of investments have performed over time in up and down markets.
- **How long do I have before I'll need the money?** If you can leave money in a 401(k) fund for 10 to 15 years or more, you may be able to ride out the ups and downs of the stock in the mutual fund. Over time, stock mutual funds have generally outperformed other options. Keep in mind that some 401(k) plans limit the number of times you can transfer your contributions from one option to another. Some plans let you switch monthly, others quarterly or yearly, while some others allow transfers on any business day.
- **How should I "mix and match" my investments?** Most financial professionals recommend that you allocate your assets to a variety of investments. Put some of your money in conservative investments with stable rates of return and distribute other assets in investments with greater potential for gains and higher risk. Your ideal "mix" will depend on your circumstances, goals, and tolerance for risk.
- **Am I a conservative, moderate or aggressive investor?** Even conservative investments may lose earning power if their growth does not outpace inflation. On the other hand, the winner-take-all attitude of very aggressive investors holds the potential for great loss as well as great gain. To help determine where your tolerance for risk lies, review the statements below.

### Conservative or Low-Risk Investor:

- I don't want to risk any of my principal.
- I want a guaranteed rate of interest on my investment.
- I am near retirement.

### **Moderate or Medium-Risk Investor:**

- I can live with some ups and downs.
- I would like a combination of high- and low-risk investments.
- I have some time for my money to grow.

### **Aggressive or High-Risk Investor:**

- I have an iron stomach and can handle market swings.
- I want the highest possible long-term rate of return, even if I risk losing short-term principal.
- I have at least 10-15 years for my investments to grow.

Whatever your investment philosophy, you should never put money in an investment you don't understand. And, remember to reconsider your investment portfolio periodically. Review it when you experience changes in your life, such as when you get married, divorced, or have a child. It is especially important to examine your investments as you approach retirement age.

### **What If I Leave My Current Employer?**

Your investment is portable - you can take the money with you. When you switch employers, you may have several options regarding your 401(k) plan money, each with its own tax implications.

- **You may be able to leave the money with your former employer.** If your new employer offers only an IRA, leaving your money with your former employer is a good idea since a 401(k) plan has numerous advantages over an IRA. Remember, however, you will not be able to borrow from the old plan or continue contributing to it.
- **You may be able to withdraw the money.** If you are 59 ½ or older, and you take your money in a lump sum, you'll be subject to ordinary income tax on the amount. If you are under 59½, and take your money in a lump sum, you'll be subject to ordinary income tax and, generally, a 10% tax penalty.
- **You may be able to transfer your 401(k) to your new employer's plan.** If the transfer goes directly from your old plan to the new, you avoid having taxes withheld. If you withdraw any of the balance, even temporarily, taxes will be withheld and penalties may be due. Not all employers will accept money from a previous 401(k) plan.

When you die, any money in a 401(k) plan, including all employer contributions, will go to your named beneficiary. If that person is your spouse, he or she will have the same options outlined above. But a beneficiary who is not your spouse will not have the rollover option. Instead, such a beneficiary will have to take the money, either in a lump sum or over a period of years not to exceed his or her life expectancy (as determined by IRS regulations).

### **What If I Need the Money Before I Retire?**

Through plan loan features, many employers allow you to borrow up to one-half of your total vested account, up to \$50,000 (reduced by any outstanding loans). If, for example, you are fully vested and have accumulated \$100,000 in your 401(k) account, you could borrow up to \$50,000. Generally, through payroll deductions, you repay the principal and current interest rates back to your account over a set term (generally not more than five years unless used for the purchase of your principal residence). In effect, you repay yourself. Immediate repayment may be required if you terminate your employment. If certain requirements are met, loans do not incur the taxes or penalties of a withdrawal.

Many plans also permit hardship withdrawals, usually for the purchase of a primary residence, payment of post-secondary education expenses, payment of certain un-reimbursed medical expenses or to prevent the eviction from or foreclosure of your principal residence. Qualified hardship withdrawals are subject to a 10% Federal income tax withholding and may be subject to a 10% early withdrawal penalty. If your plan so provides, you also can withdraw money without withdrawal penalties if you are medically disabled as defined by the IRS. Your plan may not allow you to make additional contributions for a period of time after a hardship withdrawal.

Other withdrawals taken before the age of 59½ (for example, if you change jobs and don't roll over your account) will generally incur the 10% penalty in addition to regular income taxes. Unless you are still working for the same employer, you generally must begin taking minimum distributions by April 1 of the calendar year following the calendar year in which you retire or reach age 70½ - whichever comes later. If you continue to work for the employer who is the plan sponsor after age 70½, or if you own more than 5% of the stock in the plan sponsor's company, you do not need to begin distributions at age 70½. Be sure to talk to a tax professional before making any withdrawal to be sure you fully understand the tax consequences. Under some plans, you may be required to commence distributions at age 70½ while you are still working. Other plans may allow you to choose to begin distributions at age 70½ or defer the commencement of your distributions until you retire.

### **Some Tips for Savvy 401(k) Investing**

An employer is legally required to provide a Summary Plan Description (SPD) of your 401(k), including information about eligibility, vesting and benefit payouts. The plan fiduciary may be required, however, to distribute prospectuses and financial statements on the investments. Additionally, information on your plan's investment options may come from the investment manager directly.

Remember that a prospectus is required for all mutual funds by law. Mutual funds are sold by prospectus, which is available from our registered representative. Please carefully consider investment objectives, risks, charges, and expenses before you invest. Investment return and principal value will fluctuate with changes in market conditions such that shares may be worth more or less than original cost when redeemed. Diversification cannot eliminate the risk of investment losses.

To make sound judgments regarding your 401(k) plan, you'll want to know the following:

- What is the maximum amount/percentage you can contribute?
- What is the percentage your employer will match? Is there a minimum amount you must contribute before the matching contribution kicks in? Is there a maximum?
- How many years of company service are required before you are fully vested in your employer's contributions to your 401(k)?
- How often can you transfer money between the investment options in your plan?
- When are earnings on contributions credited to your account—daily, monthly, quarterly, or annually? Earnings on contributions that are posted more frequently generally compound faster.
- How often are account balance statements provided?
- How can you access your account? Can you get updates or make transfers via computer, phone or written correspondence?
- What is the history of the investments you have chosen? Review the investment information provided with your plan. Educate yourself by spending some time online and at the local library, and read publications such as The Wall Street Journal, Barron's, Business Week, Money, Forbes, Fortune and the monthly Standard & Poor's Stock Report.
- Have you sought financial advice? You may want to consult a financial advisor, or tax professional about your family's future needs.
- Have you allocated your assets? Distributing your money across different types of investments is generally the soundest way to help reduce risk and enhance returns.

### **Make the Most of Your 401(k)**

Remember, the key to maximizing your 401(k) contributions is to start early and contribute as much as you can. Set aside the maximum amount allowed, or at least try to increase your contributions each year. And always take full advantage of any matching contributions your employer might make.

Careful planning today may help you remain one step ahead of tomorrow's inflation and can help provide you with the money you'll want to enjoy your retirement years.

### **For More Information**

## **Pamphlets From The Federal Government**

The quarterly Consumer Information Catalog lists more than 200 helpful federal publications. Obtain a free copy by calling 888-8-PUEBLO (878-3256); on the Internet at [www.pueblo.gsa.gov](http://www.pueblo.gsa.gov), or by writing: Consumer Information Catalog Pueblo, CO 81009

## **Websites**

[Frequently Asked Tax Questions And Answers: 401\(k\) Pension Plan](#) This IRS link answers frequently asked tax questions about 401(k) Pension Plans. It includes links to other IRS sites related to your retirement.

[401\(k\) Plans](#) Tax Topic 424 from the IRS on 401k Plans

[What You Should Know About Your Retirement Plan](#) This Department of Labor link provides a discussion entitled "What You Should Know about Your Retirement Plan."

[AARP](#) The American Association of Retired Persons Provides information on annuities and other topics related to financial planning for retirement.

12/05

Revised: September 2006